TAX REFORM: PROSPECTS AND POSSIBILITIES

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Mr. Chairman and Members of the Committee:

Thank you for the opportunity to testify before the House Budget Committee—one of my favorite Congressional committees because of its continual efforts to examine issues in depth. Today the topic is tax reform, that ever-elusive elf that is beginning to tease us again with its potential charm. Because of my background as the original organizer and economic coordinator of the Treasury's tax reform effort that led to the Tax Reform Act of 1986, you have asked that I reflect on some of the lessons from that period and on what might make reform possible again.

As much as I believe in this elf and the possibilities it offers for improving economic and national well-being, I am also wary about thinking about it in mystical or magical terms. I have no doubt that we can create a better tax system that can improve equity, increase economic efficiency, and simplify our lives. Nonetheless, if I have any basic message, it is that systematic tax reform—if it is to achieve true economic gains—is hard work, very hard work, requiring substantial leadership and a well-thought out vision. Here are some further reflections on that theme:

Unlike simple tax cuts or expenditure increases, *systematic* reform creates identifiable losers. Systematic reform recognizes important societal trade-offs, and trade-offs mean that something must be given up to achieve something better. Simple increases in expenditures or reductions in tax only hide elsewhere—often in future changes--those who pay for the initial changes. Th*e only way to create no losers in tax and budget policy is to maintain current law*. It is a fundamental law of budget economics and accounting that almost any budget change has an impact on the other side of the ledger. Systematic reform usually makes those losers more identifiable up front.

- Example. My Urban Institute colleague, Adam Carasso, and I have suggested combining the child credit and the Earned Income Tax Credit, which are needlessly separated. However, they have different maximum ages for eligibility. Taking an average maximum age would reduce the availability of the EITC for some college kids, thereby creating some losers. Alternatively, extending upward the child credit to the maximum age of the EITC makes the costs skyrocket, and these must be covered somehow, perhaps by reducing subsidies in some other part of the reform package.

- Example: There are many interactions among the three higher education incentives in the tax laws, as well as with Pell grants and other direct expenditures. Simplifying the law by combining them into one program or even two is likely to simplify taxes, as well as lead to a more efficient and productive use of educational incentives. But it is also likely to lead to some losers if no more revenue is made available since the combined program is likely to more rationally relate assistance to need (see Figure 1).

- Example: Saving incentives, if they are to work, must treat consistently both sides of the ledger: negative, as well as positive saving; interest payments as well as interest receipts. There are dozens of incentives today for making deposits that can be financed by borrowing, thus allowing taxpayers to arbitrage the tax system—to save taxes as if they had saved on net when they have not.

Reforming the tax system requires attention to an extraordinary range of policy issues. Being for tax reform is like being for expenditure reform, a level of generality that lacks enough specifics to give it any real meaning. There are literally hundreds of policies in play. When I set up the organization of the Treasury's 1984 tax reform study, I divided issues into roughly twenty different modules, each of which had to be examined by a team. Reforming taxes requires deciding upon policies for housing, pensions, healthcare (especially for the non-elderly), wage subsidies, charitable giving, fiscal federalism among national, state and local governments, and education, as well as tax policies for international transactions, depreciation, research and development, empowerment and enterprise zones, and local school construction—to mention only a few. One can't dodge these issues. Even when reform attempts to be more narrowly constructed so as to deal with only some of them, many stragglers force their way onto the agenda because they interact with the ones that are targeted.

- Example: The conversion of an income tax to a consumption tax must deal with the incentives for separately putting aside money for pensions and what retirement policy Congress wants to put into place.

- Example: Many programs, including tax subsidies and direct expenditures, use income accounting to determine eligibility for benefits. Therefore, elimination of income accounting for the direct income tax would not remove the requirements for income reporting and correct bookkeeping for many other purposes.

- Example: Congress has put in place a law that will soon provide an increase in tax subsidies of more than $25 billion annually for the employee exclusion for employer-provided health care. Existing subsidies are sufficient to encourage insurance purchase; the additional subsidies (from the uncapped preference) encourage the purchase of higher cost insurance. The encouragement to purchase high cost insurance leads to higher costs, which, in turn, discourages some employees and employers from offering or buying insurance. The net result of these additional subsidies, therefore, is to *increase* the number of uninsured.

High tax rates distort behavior, but they are hidden in many tax subsidies, alternative taxes, and direct expenditure programs. A few decades ago one could approximate the marginal tax rate for earning an additional dollar simply by looking at the statutory income tax rate structure. No longer. Economists now must look to the ways that alternative tax and subsidy schemes create their own implicit tax systems. Often these additional tax rates derive from the way that benefits are phased out as one's income rises.

- Example: The earned income tax credit phases out as income grows. So do many other tax subsidies, such as those for higher education. So do most transfer programs, such as food stamps. The total marginal tax rate (combining explicit and implicit taxes) for many households today, it often rises above 50 percent and frequently reaches 100 percent (see Figure 2).

- Example: Partly because of the very high tax rate on additional earnings from many tax subsidies and direct expenditure programs, most couples today face significant marriage penalties—often 10 to 20 percent, sometimes even 50 percent, of their combined income. Thus, a person making $10,000 a year could, by marrying someone making $30,000, potentially lose earned income tax credits, higher education subsidies, food stamps, housing vouchers, Medicaid, and child care allowances.

Systematic reform requires a truce from the fights over progressivity and higher statutory tax rates. Let me be clear: both progressivity and low tax rates or lean government are both worthy economic principles, even if emphasized differently on the two sides of the Congressional aisle. All families require more from their more affluent and able members, and high tax rates do distort behavior. Reform is very difficult to achieve when some advocates will fall on their swords over progressivity, and others do likewise over statutory tax rates. I am trying to make an economic, not political point: when one consideration alone is allowed to trump all others, and issues like simplicity or equal justice (equal treatment of equals) always get shoved to the side, there is a higher-than-necessary cost of taxation to the economy as a whole.

- Example: The alternative minimum tax (AMT) raises marginal and average tax rates, but few are willing to fold it into the regular rate schedule.

- Example: During the initial stages of 1984-86 tax reform process, progressivity was not an issue when deciding whether to remove, amend, or keep any particular item of tax preference. A bad preference didn't have to be kept because it was progressive, and a good preference didn't have to be removed because it was regressive. At the end of the process of choosing the tax base, Treasury would determine overall proposed progressivity of the tax system (in that case, approximating current law) by adjusting the statutory rate schedule.

The Possibilities for Tax Reform: Some Lessons from History

While it is true that reform is hard work, and equally true that opportunity is important, it is mistaken to believe that many instances of failure were due solely to the absence of opportunity. Instead, the process itself was often ill-conceived and poorly carried out. Still, while history warns us that attempts at *systematic* reform often failed, there are notable exceptions. For modern examples of systematic reform, tax bills enacted in 1954, 1969, and 1986 stand out. (Interestingly, if we follow that trend for significant reform about every 15 to 17 years, then we are about due right now.) The difficulties of reform I noted above should not deter us. Right before the Tax Reform Act of 1986, attempts at major reform had failed so many times that some writers were beginning to call it the impossible dream.

All three cases of significant tax reform involved both a felt need to act and bipartisan cooperation and bipartisan agreement on the need to move forward and to work together. The 1954 reform centered around codifying and simplifying the much more complex system that had grown up in World War II and its aftermath. Wilbur Mills, as chair of Ways and Means, exercised substantial leadership, Congressional support was quite bipartisan, and President Dwight Eisenhower approved the legislation. The 1969 reform, interestingly enough, began to be developed in 1968 under President Johnson and arose partly because of Treasury reports on abuses by foundations and on ways that wealthy taxpayers avoided paying any tax. Hardly a beat was missed when Treasury moved to Republican hands in the Nixon Administration; the work continued, eventually leading to the Tax Reform Act of 1969. In the efforts leading to the Tax Reform Act of 1986, a Treasury study galvanized support by at least some conservatives and some liberals, in no small part because of the growing use of the tax shelters of the day and because the poor increasingly were being made subject to income taxation. President Reagan and Dan Rostenkowski, chair of the Ways and Means Committee, reached an agreement not to criticize each other as the Democratic House took up what had now become the Republican President's proposal.

I cannot speak to what will lead to bipartisan cooperation today. I will state that one trend over the last couple of decades is disturbing: the dearth of useful published studies from the Executive Branch—in particular, the Treasury Department and the Office of Management and Budget—about problems that need to be addressed. But they are still good departments, so the potential is there. However, I do believe that there is current opportunity—an opportunity, if one wants, that derives, as in the past, from growing problems that need to be addressed. In this case, the complexity of the system has become even more overwhelming, and few, if any, understand what the tax system means or how it works. The scheduled movement of tens of millions of taxpayers onto the Alternative Minimum Tax is more of a political than economic problem, but the need to address it provides a catalyst for broader reform. Alternatively, the requirement to get the deficit under control also presents an opportunity to return toward base broadening (which in most cases is equivalent to a reduction in spending), as was done under President Reagan.

One Way of Viewing Tax Reform Issues

At the risk of oversimplification, tax reform issues can roughly be compartmentalized into those affecting three groups: moderate-, middle-, and higher-income taxpayers. Although there is much overlap, the issues affecting each group are often very different.

For moderate-income taxpayers, the most important tax rates derive from the phase-outs of benefit programs, including the EITC, and from the Social Security tax (which, for almost everyone for some time to come, is more than offset by the insurance value of Social Security and Medicare benefits). My work with Adam Carasso shows that many moderate- and middle-income taxpayers face combined tax rates from the phase out of EITC, Food Stamps, Medicaid and so forth of 100 percent or more for much of their earnings. Many also face enormous marriage penalties.

Some of these issues relate to provisions in the tax Code, such as the EITC and educational subsidies; some to other programs. To the extent that high tax rates distort economic behavior, it is now to the moderate-income taxpayer that we should devote our attention. Meanwhile, filing for the EITC has itself become complex, and most low-income taxpayers face more complex tax returns than many at higher income levels.

For middle-income taxpayers, combined tax rates continue to be high because of the phase-out of benefits, in this case stretching into such issues as the phase-out of educational benefits for post-secondary education programs. The middle-class gathers many benefits from dozens of exclusions, deductions, and credits in the tax system. Sometimes reformers look first to itemized deductions, but there are many other sources of preference. The number of saving incentives and retirement plan options not only adds complexity to that system; the cost of all the intermediaries—accountants, financial advisors, human resource personnel, insurance salespeople, lawyers—figuring out the tax law reduces the net return available from that saving.

For higher-income taxpayers, the issues often surround the taxation of capital income. In truth, the tax system at that income level has evolved in fitful stages, with any way to tax the rich often advocated on one side and any way to reduce their taxes advocated on the other. Much consolidation and integration could be considered, regardless of whether effective marginal tax rates are increased or reduced. An extremely important issue at higher income levels and for business is whether, for a given level of revenue collection, the tax system should favor existing wealth or new wealth. Under the Reagan tax reform, Treasury argued that lower rates were preferable to tax breaks because the latter tended to favor existing business over new business (which often couldn't generate enough taxable income to make use of special tax breaks). The alternative minimum tax started out also as a high-income tax issue but has evolved quickly downward to the middle class.

This tri-level view of the system is quite simplified and leaves to the side many issues. My main purpose in presenting it is to recognize that fixing one part often tells us very little about what to do with the other parts. One might fix up the EITC and tax rates facing low-income taxpayers without doing much about all the deductions and exclusions affecting the middle class; likewise, one might tackle those middle-class issues without considering how capital and business income is taxed, especially among those at higher incomes.

Summary

In summary, the gains in efficiency, equity, and simplicity from systematic tax reform could be substantial. However, to achieve those gains requires attention to many details. Tax reform efforts have failed often, but they have also succeeded, especially when rising problems created the opportunity and demand for reform, and tough issues were tackled in a spirit of bipartisan cooperation.